

Part I – Rulings and Decisions under the Internal Revenue Code of 1986

Section 420 – Transfers of Excess Pension Assets to Retiree Health Accounts

Rev. Rul. 2005-60

ISSUE

Is the employer subsidy for maintaining prescription drug coverage provided under section 1860D-22 of the Social Security Act (SSA), as added by section 101 of the Medicare Prescription Drug, Improvement and Modernization Act of 2003, Pub. L. 108-173 (MMA) taken into account in computing the applicable employer cost for purposes of determining whether the minimum cost requirement of section 420(c)(3) is satisfied?

FACTS

Company M, a calendar year taxpayer, maintains Plan A, a single employer defined benefit plan qualified under section 401(a) of the Internal Revenue Code. Company M also maintains Plan B, a retiree medical benefit plan. In 2005, in accordance with section 420 of the Code, Company M transfers a portion of Plan A's assets to an account described in section 401(h) in order to provide for retiree medical benefits under Plan B. Company M's applicable employer cost was \$3,600 for 2003, \$3,800 for 2004 and \$4,000 for 2005. By September 30, 2005 Company M applies for the employer subsidy for maintaining prescription drug coverage pursuant to section 1860D-22 of SSA. In 2006, Company M receives a payment of the employer's subsidy in an amount equal to \$600 per covered retiree. In 2006, the aggregate amount paid by Company M with respect to applicable health benefits, without regard to the

employer subsidy for maintaining prescription drug coverage, is \$4,300 per covered retiree.

LAW AND ANALYSIS

Section 420(a) provides that if there is a qualified transfer of any excess pension assets of a defined benefit plan (other than a multiemployer plan) to a health benefits account which is part of the plan, the related trust is not treated as failing to meet the requirements of section 401(a) or (h) solely by reason of the transfer. In addition, no amount is includible in gross income of the employer solely by reason of the transfer, and the transfer is not treated as an employer reversion for purposes of section 4980 or as a prohibited transaction for purposes of section 4975.

Among the requirements for a transfer to be a qualified transfer, as defined in section 420(b), is that the minimum cost requirements of section 420(c)(3) must be satisfied. Section 420(c)(3)(A) provides, in relevant part, that each group health plan or arrangement under which applicable health benefits are provided must provide that the applicable employer cost for each taxable year during the cost maintenance period is not less than the higher of the applicable employer costs for each of the 2 taxable years immediately preceding the taxable year of the qualified transfer.

Section 420(c)(3)(B) generally defines applicable employer cost for a taxable year as the amount determined by dividing the qualified current retiree health liabilities of the employer for the year by the number of individuals to whom coverage for applicable health benefits was provided during the year. Section 420(c)(3)(C) allows the minimum cost requirements to be applied separately with regard to individuals

eligible for benefits under Title XVIII of the Social Security Act. Under section 420(c)(3)(D), the cost maintenance period is the period of 5 taxable years beginning with the taxable year in which the qualified transfer occurs. Section 420(c)(3)(E) provides that the Secretary shall prescribe such regulations as may be necessary to prevent an employer who significantly reduces retiree health coverage during the cost maintenance period from being treated as satisfying the minimum cost requirement. Section 420(c)(3)(E) also provides that an employer will not be treated as reducing retiree health coverage when an employer reduces applicable employer cost by an amount not in excess of the reduction in cost which would have occurred if the employer had made the maximum permissible reduction in retiree health coverage permitted under the regulations.

Section 420(e)(1)(A) defines “qualified current retiree health liabilities” as the aggregate amounts (including administrative expenses) which would have been allowable as a deduction to the employer for the taxable year with respect to applicable health benefits provided during the year if (i) the benefits were provided directly by the employer, and (ii) the employer used the cash receipts and disbursements method of accounting. Section 420(e)(1)(C) defines “applicable health benefits” as health benefits or coverage which are provided to (i) retired employees who, immediately before the qualified transfer, are entitled to receive such benefits upon retirement and who are entitled to pension benefits under the plan, and (ii) their spouses and dependents.

Section 1860D-22 of SSA provides a subsidy for sponsors of retiree prescription drug plans that provide drug coverage that is at least “actuarially equivalent” to the Medicare Part D benefit. The subsidy is available only with respect to retirees who are

eligible for, but do not enroll in, Medicare Part D and who are covered under the employer's retiree prescription drug plan.

Section 139A of the Code provides that gross income does not include any employer subsidy payment received under section 1860D-22 of SSA. Under section 139A this exclusion is not taken into account in determining whether any deduction is allowable with respect to any cost taken into account in determining the payment.

The applicable employer cost is based on qualified current retiree health liabilities which in turn is based on aggregate amounts which would be allowable as a deduction to the employer for the taxable year with respect to applicable health benefits. In accordance with section 139A, the determination of the aggregate amounts which would be allowable as a deduction to the employer for the taxable year with respect to applicable health benefits is made without regard to the employer subsidy for maintaining prescription drug coverage. Accordingly, the receipt of that subsidy is not taken into account in determining applicable employer cost. Company M satisfies the minimum cost requirements of section 420(c)(3) for 2006 because the applicable employer cost of \$4,300 is not less than \$3,800 (the higher of the applicable employer cost for 2003 and 2004).

HOLDING

The employer subsidy for maintaining prescription drug coverage provided under Section 1860D-22 of SSA as added by section 101 of MMA is not taken into account in computing the applicable employer cost for purposes of determining whether the minimum cost requirement of section 420(c)(3) is satisfied.

DRAFTING INFORMATION

The principal drafter of this revenue ruling is Kathleen Herrmann of the Employee Plans, Tax Exempt and Government Entities Division. For further information regarding this revenue ruling, please contact the Employee Plans' taxpayer assistance telephone service at 1-877-829-5500 (a toll-free number) between the hours of 8:00 a.m. and 6:30 p.m. Eastern Time, Monday through Friday. Ms. Herrmann may be reached at (202) 283-9888 (not a toll free number).